Securities Industry Trends

ANNUAL SUBSCRIPTION
$48.00 member • $72.00 non-member

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

4/18/86 A8825-1

Vol. XII, No.4 April 9, 1986

1985's SECURITIES INDUSTRY PROFITABILITY REBOUND

Highlights

1. In 1985, the securities industry earned a record net income, both on a pre- and after-tax basis. The $4.1 billion pre-tax profit achieved last year was up 158% over 1984. Any applauds, though well deserved, over that rise must be tempered with the memory of how poor a year 1984 was to begin with. Compared to better times back in 1983, last year's pre-tax record profits were only ahead 7.9%.

2. Since profits were at record levels, naturally revenues were also. Last year's $38.6 billion showing in this area was up 23.7% over 1984 and 30.4% over 1983. The big story is that this revenue rise far outpaced rises in expenses which translates into a fatter bottom line.

3. The best showing in profitability and revenue gains were all during the fourth quarter. With the bull market in full swing during those months the pace of gains was torrid...at levels experienced during the industry's best years. In fact, the $1.5 billion pre-tax profit in 1985's final quarter was second only to the $1.6 billion earned in 1982's final three months. This hopefully will carry over into record showings in 1986's first quarter.

4. One factor which drove the bull market which in turn fueled the profit gains also had counterbalancing effects. For instance, falling interest rates (last summer for the first time since 1978, the prime rate returned to single digit levels) kept revenues from margin interest from doing better than it could have on 1985's record activity.

5. The industry's balance sheet has been expanding, but more so on the liability side. At last year's close total liabilities hit a record $394 billion while total ownership equity also hit a record $17 billion.

Table 1

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY
(In $ millions)

	1980	1981	1982	1983	1984	1985
REVENUE						
Commissions	5682.1	5339.6	6011.9	8350.2	7094.6	8238.4
Listed Equities, On an Exchange	4237.5	3954.7	4484.1	6131.5	5232.6	6069.8
Listed Equities, OTC	44.6	72.8	61.0	112.4	75.0	92.3
Options	714.8	608.4	737.4	797.5	822.3	881.4
All Other	685.2	703.6	728.9	1308.6	964.7	1205.0
Gains/Losses from Trading Accounts	3137.8	4237.5	5951.5	6839.0	7563.8	9944.3
Mkt Making-OTC Equities	664.4	607.3	655.7	1381.3	862.9	1229.8
OTC Mkt Making-Listed Equities	60.3	38.3	37.7	51.7	45.7	52.5
Trading-Debt Securities	1894.2	3081.3	4454.8	4418.1	5524.9	7206.5
Mkt Making-Options	1.9	-1.0	11.1	63.6	31.1	159.1
All Other Trading	577.3	549.7	828.4	982.7	1147.7	1348.7
Gains/Losses from Investment Accounts	560.1	573.7	606.8	738.1	713.8	1089.2
Realized Gains/Losses	426.2	570.1	380.1	495.7	697.7	837.9
Unrealized Gains/Losses	104.0	-23.7	159.9	166.2	-10.4	187.3
Profits/Losses from Underwriting	1327.8	1568.1	2316.1	3541.4	2706.1	4250.3
From Equities	403.3	424.1	328.2	754.5	248.3	748.4
Margin Interest	2088.7	2890.1	2010.5	2129.5	2867.8	2577.7
Revenue from Sale of Investment Company Shares	104.7	122.0	287.5	952.1	750.9	1642.8
Fees-Supervision,Advisory,Administrative	175.4	274.8	356.1	569.5	693.8	947.4
Revenue from Research Services	14.3	15.8	8.3	18.7	11.1	17.6
Commodities Revenue	625.4	580.5	663.0	826.1	739.3	983.2
Other Revenue-Securities-Related	1727.6	2965.4	3942.3	4385.0	6282.8	7176.4
Other Revenue	586.1	1229.1	1055.9	1216.8	1792.1	1757.7
Total Revenue	16029.7	19796.1	23210.0	29566.4	31216.0	38621.2
EXPENSES						
RR Compensation	3049.8	3334.2	4103.6	5750.2	5248.5	6903.
Clerical & Admin. Employee Expenses	2548.1	3086.3	3702.8	4889.8	5147.5	6218.5
Partners & Officers - Employment Expenses	567.8	648.2	753.9	982.1	934.1	1119.9
Other Employee Comp. *	169.7	190.5	258.0	448.2	396.1	331.3
Floor Expenses	753.6	725.4	863.8	1142.9	1162.6	1310.3
Brokerage Paid to Brokers	263.2	265.3	316.7	390.1	399.1	441.9
Commissions & Clearance	283.0	246.6	275.7	390.4	395.3	459.5
Clearance Paid to Non-brokers	162.2	156.1	207.9	246.6	257.9	285.3
Commissions Paid To Others *	45.2	57.4	63.5	115.8	110.3	123.6
Communications	837.5	1103.3	1270.3	1538.4	1766.4	1921.8
Occupancy & Equipment	514.1	678.4	853.3	1138.4	1503.7	1830.7
Promotional Costs	347.2	456.9	530.2	735.1	769.2	841.5
Interest Expense	3444.8	5684.7	5480.7	6057.5	9505.4	10127.6
Losses-Errors and Bad Debts	204.5	153.6	193.3	233.0	212.0	266.3
Data Processing Costs	156.1	216.7	273.1	342.8	419.8	477.8
Non-recurring Charges	30.9	16.7	6.9	98.5	26.2	98.9
Regulatory Fees and Expenses	65.9	79.2	100.9	133.9	144.9	244.8
Other Expenses	1077.2	1280.7	1784.3	2251.3	2372.3	2797.4
Total Expenses	13767.4	17651.8	20175.4	25742.9	29608.2	34481.2
Net Income	2262.3	2144.3	3034.6	3823.5	1607.8	4140.0
Net Income-After Tax	1221.6	1157.9	1638.7	2064.7	868.2	2235.6

* From FOCUS Short Form, IIA

INTRODUCTION

1985: THE START OF SOMETHING GOOD FOR THE SECURITIES INDUSTRY

Based on last year's bonus checks at securities firms, the Dow, the Bond Buyer Index, etc., everyone knew 1985 was a great deal better than 1984. But now it is official. The full year financials for all NYSE member firms doing a public business are now completed, processed, studied and analyzed. And what they show is HOW it was better, WHY it was better and WHERE it can improve.

In general, after 1984's disastrous showing by the securities industry, the second act had to be better. And it was...much better. Full year 1985's profitability shot back up sharply, but still failed to match levels of better days in the early Eighties. The fourth quarter, however, was the bonanza period where all major revenue and profitability gains mirrored the steep climb in the markets as the bull gained momentum. During this period, profitability measures, such as quarterly ROE, did match the best showings the industry mustered in years 1981 through 1983.

Low inflation and falling interest rates drove this bull market and the bull towed the industry along. Last year's favorable climate for the industry is still warming up today, with inflation and interest rates falling further, the bull market keeps sending market indices to higher record levels.

A walk through the industry's income statement and balance sheet will show what the good news, as well as the bad, is.

REVENUES - THAT'S MORE LIKE IT

Out of the ashes of a pitiful 1984 for most of the securities industry arose a strong 1985. Last year, securities industry revenues for NYSE firms dealing with the public galloped ahead 23.7% to a record $38.6 billion. This rise was in line with the industry's best years that followed the phenomenal 1980 (when revenues soared 42.9%) comparing favorably to 1981 and 1983 (revenues up 23.8% and 27.6%, respectively.) What was even better - revenue increases far outpaced rising expenses, up 16.6%, to show an impressive 158% increase in securities industry profitability last year.

The $31.1 billion of revenues posted in the previous year, 1984, also showed a year-to-year increase but much less so - only 5.4%. But the real story in 1984 was that expenses increased at a much faster pace than revenues, 15.2% vs 5.4%, so that 1984 industry profitability dove almost 58% from 1983. If we ignore 1984 and look at the two most recent favorable years, 1985 vs 1983, we receive a clearer picture on how the industry is doing in keeping its costs in line with revenue growth, thereby generating greater profits.

Table 2

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY
PERCENT OF TOTAL REVENUES

	1980	1981	1982	1983	1984	1985
REVENUE						
Commissions	35.4	27.0	25.9	28.2	22.7	21.3
Listed Equities, On an Exchange	26.4	20.0	19.3	20.7	16.8	15.7
Listed Equities, OTC	0.3	0.4	0.3	0.4	0.2	0.2
Options	4.5	3.1	3.2	2.7	2.6	2.3
All Other	4.3	3.6	3.1	4.4	3.1	3.1
Gains/Losses from Trading Accounts	19.6	21.4	25.6	23.1	24.2	25.7
Mkt Making-OTC Equities	4.1	3.1	2.8	4.7	2.8	3.2
OTC Mkt Making-Listed Equities	0.4	0.2	0.2	0.2	0.1	0.1
Trading-Debt Securities	11.8	15.6	19.2	14.9	17.7	18.7
Mkt Making-Options	0.0	0.0	0.0	0.2	0.1	0.4
All Other Trading	3.6	2.8	3.6	3.3	3.7	3.5
Gains/Losses from Investment Accounts	3.5	2.9	2.6	2.5	2.3	2.8
Realized Gains/Losses	2.7	2.9	1.6	1.7	2.2	2.2
Unrealized Gains/Losses	0.6	-0.1	0.7	0.6	0.0	0.5
Profits/Losses from Underwriting	8.3	7.9	10.0	12.0	8.7	11.0
From Equities	2.5	2.1	1.4	2.6	0.8	1.9
Margin Interest	13.0	14.6	8.7	7.2	9.2	6.7
Revenue from Sale of Investment Company Shares	0.7	0.6	1.2	3.2	2.4	4.3
Fees-Supervision,Advisory,Administrative	1.1	1.4	1.5	1.9	2.2	2.5
Revenue from Research Services	0.1	0.1	0.0	0.1	0.0	0.0
Commodities Revenue	3.9	2.9	2.9	2.8	2.4	2.5
Other Revenue-Securities-Related	10.8	15.0	17.0	14.8	20.1	18.6
Other Revenue	3.7	6.2	4.5	4.1	5.7	4.6
Total Revenue	100.0	100.0	100.0	100.0	100.0	100.0
EXPENSES						
RR Compensation	19.0	16.8	17.7	19.4	16.8	17.9
Clerical & Admin. Employee Expenses	17.9	15.6	16.0	16.5	16.5	16.1
Partners & Officers - Employment Expenses	3.5	3.3	3.2	3.3	3.0	2.9
Other Employee Comp. *	1.1	1.0	1.1	1.5	1.3	0.9
Floor Expenses	4.7	3.7	3.7	3.9	3.7	3.4
Brokerage Paid to Brokers	1.6	1.3	1.4	1.3	1.3	1.1
Commissions & Clearance	1.8	1.2	1.2	1.3	1.3	1.2
Clearance Paid to Non-brokers	1.0	0.8	0.9	0.8	0.8	0.7
Commissions Paid To Others *	0.3	0.3	0.3	0.4	0.4	0.3
Communications	5.2	5.6	5.5	5.2	5.7	5.0
Occupancy & Equipment	3.2	3.4	3.7	3.9	4.8	4.7
Promotional Costs	2.2	2.3	2.3	2.5	2.5	2.2
Interest Expense	21.5	28.7	23.6	20.5	30.5	26.2
Losses-Errors and Bad Debts	1.3	0.8	0.8	0.8	0.7	0.7
Data Processing Costs	1.0	1.1	1.2	1.2	1.3	1.2
Non-recurring Charges	0.2	0.1	0.0	0.3	0.1	0.3
Regulatory Fees and Expenses	0.4	0.4	0.4	0.5	0.5	0.6
Other Expenses	6.7	6.5	7.7	7.6	7.6	7.2
Total Expenses	85.9	89.2	86.9	87.1	94.8	89.3
Net Income	14.1	10.8	13.1	12.9	5.2	10.7

* From FOCUS Short Form, IIA

The $38.6 billion in revenues achieved in 1985 were up 30.4% over 1983. The $34.5 billion in expenses incurred last year, though not up much from 1984, were still up 34.2% over 1983. That's a slightly faster increase than revenue growth. Therefore, though profitability increased a dramatic 158% from $1.6 billion in 1984 to $4.1 billion last year, the industry is really doing only 7.9% better than back in 1983 when pre-tax profits were $3.8 billion (excluding extraordinary gains/losses). Thus, self-satisfaction should be more modest than first blush appearances from the euphoria of 1986.

Most of the thanks for the revenue gains goes to the bull market. The fourth quarter was by far the year's best quarter for revenues with $11.6 billion received during that period or 30.1% of 1985's total. A comparatively modest rise in gross margin interest revenue kept fourth quarter revenue gains from being even more impressive. Interest rates fell (the prime rate finally returned to single digit levels last summer, the first time it was below 10% since 1978) counterbalancing a rise in margin debt outstanding to a record $28.4 billion in December.[1/]

By category of revenue, it was practically an across the board sweep for the fourth quarter with every major revenue source posting its 1985 quarterly high and only some minor revenue categories being nudged out slightly by prior quarters. Commission revenue, principal activities, underwriting profit, margin interest and other securities business related revenue all had their best showing in the final quarter. Just how these revenue areas did are discussed below.

COMMISSIONS - LESS BANG PER BUCK

Though the current super bull market's euphoria may have dimmed some memories of the year just gone by, 1985's securities industry record performance should not be bowed to and then forgotten since, upon analysis, it reveals many of the trends still driving the industry towards hopefully another record year of profits.

Commission dollars continue to be one of the major industry revenue sources, though less so than several years ago. In the aggregate, revenues generated through commissions last year bounced back sharply from 1984's level and almost, but not quite, matched the record amount generated in 1983's bull market. The $8.2 billion of commission dollars raised in 1985 were up a hefty 15.5% over 1984, when only $7.1 billion was received. The 1983 record was $8.4 billion, just overshadowing last year's commission revenues.

1/NYSE Marketing Research Report, 3/18/86.

Table 3

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY
(In $ millions)

	1985:1	1985:2	1985:3	1985:4
REVENUE				
Commissions	2155.6	1973.7	1857.8	2251.3
Listed Equities, On an Exchange	1605.2	1474.2	1353.7	1636.7
Listed Equities, OTC	20.8	22.3	23.2	26.0
Options	236.2	200.6	181.1	263.5
All Other	293.5	276.8	299.9	334.8
Gains/Losses from Trading Accounts	2342.8	2469.1	2099.2	3033.2
Mkt Making-OTC Equities	350.3	276.3	234.9	368.3
OTC Mkt Making-Listed Equities	16.6	12.1	10.9	12.9
Trading-Debt Securities	1636.2	1888.7	1529.7	2151.9
Mkt Making-Options	23.7	62.7	13.8	58.9
All Other Trading	333.1	241.4	320.8	453.4
Gains/Losses from Investment Accounts	290.6	227.2	144.6	426.8
Realized Gains/Losses	214.2	199.1	70.9	353.7
Unrealized Gains/Losses	56.9	6.8	91.6	32.0
Profits/Losses from Underwriting	698.8	1007.4	1012.8	1531.3
From Equities	124.3	162.7	245.3	216.1
Margin Interest	584.8	622.7	661.6	708.6
Revenue from Sale of Investment Company Shares	323.2	451.0	482.6	386.0
Fees-Supervision,Advisory,Administrative	191.3	217.5	244.7	293.9
Revenue from Research Services	2.2	4.9	7.5	3.2
Commodities Revenue	227.0	327.2	276.3	152.7
Other Revenue-Securities-Related	1736.4	1553.2	1606.2	2280.6
Other Revenue	396.7	381.3	447.3	532.4
Total Revenue	8949.6	9234.2	8840.5	11595.9
EXPENSES				
RR Compensation	1552.7	1741.0	1699.3	1910.6
Clerical & Admin. Employee Expenses	1392.9	1541.6	1469.0	1815.0
Partners & Officers - Employment Expenses	288.6	271.4	262.2	297.7
Other Employee Comp. *	84.0	86.4	78.8	82.1
Floor Expenses	334.8	329.1	298.5	347.9
Brokerage Paid to Brokers	114.1	104.5	103.6	119.7
Commissions & Clearance	121.1	108.4	111.2	118.8
Clearance Paid to Non-brokers	68.5	86.5	55.8	74.5
Commissions Paid To Others *	31.1	29.7	27.9	34.9
Communications	463.4	478.9	486.7	492.8
Occupancy & Equipment	429.8	433.0	463.7	504.2
Promotional Costs	186.0	197.7	198.3	259.5
Interest Expense	2465.4	2148.9	2312.5	3200.8
Losses-Errors and Bad Debts	44.9	69.9	66.5	85.0
Data Processing Costs	96.9	129.2	123.3	128.4
Non-recurring Charges	2.8	5.9	30.4	59.8
Regulatory Fees and Expenses	50.8	53.4	63.6	77.0
Other Expenses	622.7	723.3	591.3	860.1
Total Expenses	8015.9	8209.7	8133.1	10122.5
Net Income	933.7	1024.5	707.4	1474.4
Net Income-After Tax	504.2	553.2	382.0	796.2

Though last year's near record commissions' showing was a welcome contributor to the Street's bottom line, there were a couple of caveats in this billion dollar bonus. First, securities firms had to sell a lot more product to earn the same commission dollar. Back in 1983 when total commission dollar revenue hit the record $8.4 billion, the bulk, as always ($6.1 billion), came from trades of listed equities executed on an exchange. That represented 0.67%[2/] of the total value of those equities traded in 1983 on the exchanges. In the following year, commission revenues from trades on an exchange fell to 0.58% of the underlying value of the shares traded. Last year, as exchange traded equity commissions bounced back to the 1983 level, $6.1 billion, the ratio to the value of shares traded eroded further to only 0.50%. This represents a worrisome 25.4% decrease (0.67% vs 0.50%) in commission dollars relative to the underlying securities in just two years although part of the drop, to be explained shortly, actually has a favorable ramification.

Moreover, the relative contribution of commission dollars to the securities industry's revenues continues to decline. In 1983, commission dollars represented 28.2% of revenues. In 1984, this ratio dropped dramatically to 22.7%, albeit not a very good year to begin with. It was also the first time gains from trading outdistanced commission revenues. Last year, however, as the industry set new revenue and profitability records, commission dollars were playing an even less important part of its growth, contributing only 21.3% to the total revenue pie.

Clearly, the industry finds itself in the position that each year it needs more commission transactions to generate the same commission dollar. This held true in both down (1984) and up (1985) markets.

There appears to be two main explanations for this erosion. First, overall commission rates have been falling for years. This is due to the increased institutionalization of the marketplace and the inherent lower rates with these trades. This has also been one of the contributing factors to the increased competitive atmosphere the Street now works in which in turn has helped drive institutional rates downward.

The second factor has been a shift towards more risk taking in execution. And with the risk, at least in this case, comes greater reward. As securities firms handle more of their equity transac'ions on a principal basis vs agency, the income

---

2/ Commission revenues from equity sales executed on an exchange as reported on FOCUS reports to the NYSE, divided by the dollar value of shares traded on NYSE, AMEX and regional exchanges, as reported by those exchanges.

Table 4

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY
PERCENT OF TOTAL REVENUES

	1985:1	1985:2	1985:3	1985:4
REVENUE				
Commissions	24.1	21.4	21.0	19.4
Listed Equities, On an Exchange	17.9	16.0	15.3	14.1
Listed Equities, OTC	0.2	0.2	0.3	0.2
Options	2.6	2.2	2.0	2.3
All Other	3.3	3.0	3.4	2.9
Gains/Losses from Trading Accounts	26.2	26.7	23.7	26.2
Mkt Making-OTC Equities	3.9	3.0	2.7	3.2
OTC Mkt Making-Listed Equities	0.2	0.1	0.1	0.1
Trading-Debt Securities	18.3	20.5	17.3	18.6
Mkt Making-Options	0.3	0.7	0.2	0.5
All Other Trading	3.7	2.6	3.6	3.9
Gains/Losses from Investment Accounts	3.2	2.5	1.6	3.7
Realized Gains/Losses	2.4	2.2	0.8	3.0
Unrealized Gains/Losses	0.6	0.1	1.0	0.3
Profits/Losses from Underwriting	7.8	10.9	11.5	13.2
From Equities	1.4	1.8	2.8	1.9
Margin Interest	6.5	6.7	7.5	6.1
Revenue from Sale of Investment Company Shares	3.6	4.9	5.5	3.3
Fees-Supervision,Advisory,Administrative	2.1	2.4	2.8	2.5
Revenue from Research Services	0.0	0.1	0.1	0.0
Commodities Revenue	2.5	3.5	3.1	1.3
Other Revenue-Securities-Related	19.4	16.8	18.2	19.7
Other Revenue	4.4	4.1	5.1	4.6
Total Revenue	100.0	100.0	100.0	100.0
EXPENSES				
RR Compensation	17.3	18.9	19.2	16.5
Clerical & Admin. Employee Expenses	15.6	16.7	16.6	15.7
Partners & Officers - Employment Expenses	3.2	2.9	3.0	2.6
Other Employee Comp. *	0.9	0.9	0.9	0.7
Floor Expenses	3.7	3.6	3.4	3.0
Brokerage Paid to Brokers	1.3	1.1	1.2	1.0
Commissions & Clearance	1.4	1.2	1.3	1.0
Clearance Paid to Non-brokers	0.8	0.9	0.6	0.6
Commissions Paid To Others *	0.3	0.3	0.3	0.3
Communications	5.2	5.2	5.5	4.2
Occupancy & Equipment	4.8	4.7	5.2	4.3
Promotional Costs	2.1	2.1	2.2	2.2
Interest Expense	27.5	23.3	26.2	27.6
Losses-Errors and Bad Debts	0.5	0.8	0.8	0.7
Data Processing Costs	1.1	1.4	1.4	1.1
Non-recurring Charges	0.0	0.1	0.3	0.5
Regulatory Fees and Expenses	0.6	0.6	0.7	0.7
Other Expenses	7.0	7.8	6.7	7.4
Total Expenses	89.6	88.9	92.0	87.3
Net Income	10.4	11.1	8.0	12.7

* From FOCUS Short Form, IIA

from this sector will not be reflected in commission revenues but rather as gains or losses from these trades.

Last year, the net gain from making an OTC market in listed securities rose 14.9% to $52.5 million from $45.7 million in 1984. Though this is a small part of all principal transactions, particularly considering fixed income instruments, it does support the trend. Where the real explosion in principal transactions lies is discussed below.

TRADING - THE BREAD & BUTTER BUSINESS LINE

Taking a principal position in trading OTC & listed securities has helped this area of revenues prosper but the big picture, all principal trading activities (debt, equities, options) and investment account gains, is where the big money is. Last year, these functions generated $11 billion in net revenues, a new record, up 32.5% from the previous record $8.3 billion set the prior year and triple the level from these activities just five years earlier. This represented 28.5% of all industry revenues last year, by far the industry's new bread and butter business line. Again the trend is towards even better results in the current bull. Of the $11 billion, $3.5 billion, or 31.8% of the year's total, came in the final quarter. That represented an even higher ratio of revenues, 30.2% for the final quarter, compared to the impressive 28.5% for the entire year.

The big ball of wax, as always, came from trading debt. But last year's record $7.2 billion for this area was worthy of an entire wax museum. That figure was up 30.9% from the previous year, 1984's then record $5.5 billion, and up 63.6% over 1983. It was also the most important single product line for the industry last year bringing in 18.7% of all revenues.

The fourth quarter's $2.2 billion (best for the year) showing was not surprising, though perfectly welcome, since the secondary debt market volume over this period headed to record levels. As measured by the market value of corporate debt traded by institutions in the secondary market (excluding member trading), the average daily volume skyrocketed from $8.9 billion in September to a record $12.7 billion in December.3/ Again, according the SIA's Investor Activity Report, the trend is mighty favorable for debt traders this year. That December record continued to be broken in each of this year's first two months...up to $12.9 billion daily in January and a staggering $15.1 billion daily in February.

Revenue from gains in investment accounts were up 40% last year...setting a new record by breaking through the billion

---

3/SIA Investor Activity Report, December 1985 issue.

dollar barrier with $1.1 billion posted in 1985. Again the fourth quarter had the best showing, accounting for 39.2% of the year's total.

And while the secondary markets were having a field day, the primary markets were having a picnic of their own.

UNDERWRITING REVENUE SOARS

Origination, underwriting and selling group revenues last year exploded 59.3% over 1984's $2.7 billion to a new record, $4.3 billion. Though a large amount of that total is increasingly concentrated in a few big hands, the $4.3 billion, 22.9% better than the previous record in 1983, helped a lot of bottom lines from coast to coast.

Investment banking divisions were heartened to see their contribution to the industry's total revenues ricochet back to 11.0% from 8.7% the previous year. Though this didn't match the 12.0% contribution underwriting made in 1983, in perspective it must be remembered that 1985's tasty underwriting slice came from one heck of a large revenue pie. Also, 1983 was the record equity year based on the dollar volume of equity underwritings (where the larger spreads are). Such offerings in 1983 made up one-fifth of the total dollar volume of all primary market deals compared to less than 9% last year.[4/]

The year-to-year 59.3% underwriting revenue increase was hardly surprising, though no less sweet because of that. On the corporate side, the precipitous interest rate drop in a year's span had profound effects. As measured by many rate indicators such as Fed funds, commercial paper, Euro deposits, or either short or long Treasuries, 1985's average rate fell around 200 basis points from 1984, while continuing an impressive downward movement to-date.[5/] Taxable debt issues were flooded onto the domestic markets at a record clip, topping out at $105 billion[6/] as corporate treasurers scrambled for cheap funds and to refund mammoth amounts of high cost debt issued earlier.

4/Investment Dealers' Digest and Public Securities Association.

5/Federal Reserve Bulletin, March 1986.

6/Investment Dealers' Digest.

The rosy rate picture coupled with the economy's best disinflationary environment in decades spilled the enthusiasm over into the equity markets. Everything went up. There were 26% to 31% gains in the DJIA, the NYSE Common Stock Index, S&P's 500 and the NASDAQ Composite indices. Even the AMEX's Market Value Index reversed a three year down pattern by posting a 20% gain.

The result on equity underwriting obviously had the multiplier effect with the value of equity underwritings mushrooming 154% to $33.3 billion...second only to 1983's incredible $45 billion of equity offering.[7/]

That was still an impressive amount especially in the light of 1983 having about twice as many common stock offerings than last year overall, and also double the number of deals in some categories, such as thrift conversions, according to Investment Dealers' Digest.

This rate picture, coupled with proposed tax changes, also catapulted the muni markets. This arena saw an unheard of $241 billion underwritten last year.[8/] Not only was that a record, it equalled the sum of the two previous record years together, 1983 and 1984. The net of tax interest rates for munis matched their corporate cousins' decline while nominally shedding 100 basis points as measured by triple-A or Baa G.O. paper or by the Bond Buyer's Index.[9/] Though rates were the major factor in all credit markets last year, this doubling of muni volume was helped in no small part by threatened tax legislation affecting interest on municipal securities, caps on municipal borrowings and types of tax-exempt financings.

While rates can explain a rise from $16 billion in corporate debt underwritten in the first quarter to $34 billion in the fourth (with a slightly larger 58% of the year's $105 billion in debt underwritten in the second half[10/]), it can't by itself explain what happened to the muni market. According to Investment Dealers' Digest, half of last year's incredible muni volume was underwritten solely in the final quarter, with December alone accounting for one-quarter of 1985's volume.

7/Investment Dealers' Digest.

8/Public Securities Association.

9/Federal Reserve Bulletin, March 1986.

10/Investment Dealers' Digest.

Again, much of this activity was an attempt to finance before tax proposals became law, particularly to beat a proposed January 1, 1986 date which might have affected certain municipal financings.

The muni floodgate has now been closed. According to IDD, only a miniscule $11 billion was underwritten in 1986's first quarter. That's less than 5% of last year's total volume. Part of the dearth is explained by municipalities which already completed their immediate financing needs during last year's new issue flood. The other is the tax proposal overhang problem. This scenario was, unfortunately, further exacerbated this year with additional proposals carrying more negative implications. For instance, this March Senate Finance Committee Chairman, Robert Packwood, amended his original proposal to subject muni income to the 20% alternative tax from only newly issued bonds to all existing bonds. This announcement sent a shock wave through the muni markets. It even created a "The Day The Earth Stood Still" atmosphere in muni land on March 19, with trading virtually halted on the Big Board for an hour and several investment banks temporarily shutting down muni activities.11/ However, the proposal was voted down and once the tax picture is finalized the chaotic atmosphere should disappear since, as the adage goes, the markets can handle anything but uncertainty.

On a positive note, though the muni floodgates were shut, the corporate waterfall continues to mirror Niagara with a new quarterly record hitting $68 billion underwritten in this year's first quarter.12/

MARGIN INTEREST - EVERY SILVER LINING HAS A CLOUD

With securities industry records being set left and right, something had to be off. Gross margin interest was one of those things. Last year, interest earned on margin accounts in the industry fell 10.3% from $2.9 billion to $2.6 billion. It wasn't that customers weren't buying on margin, in last year's bull market they were doing so at a record clip. According to the NYSE data, average monthly margin debt was up 10.1% last year from $22.7 billion per month in 1984, to $25.0 billion per month in 1985.13/ But this increase was more than offset by

---

11/Wall Street Journal, 3/20/86.

12/Investment Dealers' Digest.

13/Based on monthly margin debt reported in NYSE's Marketing Research Report, 3/18/86.

the same gremlin which was driving the bull - interest rates. If rates had held up through 1985 at the average 200 basis points higher they were in 1984, margin interest on that $25 billion average monthly debt could have increased margin interest revenue another $500 million. Naturally, such a trend would have impeded the bull market in most securities and all the other wonderful things rate declines did for the industry.

On another positive note, for the first two months of this year, the Bid Board reports monthly margin debt continuing to increase. In January, it was $26.8 billion and then up to $27.5 billion in February.[14]

OTHER DEPARTMENTS HAD GOOD NEWS TOO

Syndicate managers and principal traders weren't the only ones smiling last year. Revenues from sales of mutual funds skyrocketed and income from this area made even banner year 1983 look anemic by comparison. On a year-to-year basis, this revenue source more than doubled from $751 million in 1984 to $1.6 billion last year. It was also up 72.6% over the very profitable $952 million raked in from these sales in 1983. This source of revenue also increased in importance relative to all revenue sources. Last year, revenue from sales of investment company shares comprised 4.3% of all revenue vs. 3.2% in 1983 and 2.4% in 1984.

In 1984 if it wasn't for the increase of $1.9 billion in revenue related to the securities business, the year would have been in the red. Last year, though up in aggregate, this field was not the same life saver. This income source, generally attributed to M&A activities, private placements and repo activities, increased 14.3% last year to $7.2 billion while total revenues were up 23.7%. Declining interest rates effect on the repo business explains this relatively modest increase. This is similar to what happened to margin interest as a revenue source. Overnight and term repurchase agreements have steadily been rising for years with their best ever quarter being 1985's final one.[15] Yet, declining rates outpaced the growth in this field yielding smaller per dollar returns. Still, these securities related billions are nothing to sneeze at, comprising 18.6% of all revenue last year. That is much better than in 1983 when the $4.4 billion from this source comprised only 14.8% of total revenue and still pretty close to 1984's 20.1% when a majority of other revenue sources either actually declined or fell as a percent of total revenues.

---

[14] Based on monthly margin debt reported in NYSE's Marketing Research Report, 3/18/86.

[15] Data Resources, Inc. Review of the U.S. Economy.

Though it may be considered bad luck to knock a 14.3% increase in other securities related revenue, especially when it is contributing 18.5% to total industry revenue, the figure is somewhat disappointing considering the heyday activity which occurred in its three major generating fields.

According to the Chicago-based merger consultant, W.T. Grimm & Co, M&A activity last year was nothing short of phenomenal. The $180 billion of 1985 M&A activity shattered the previous record set in 1984, climbing a staggering 47% from that year's $122 billion. Granted, just over half that volume came from just 36 transactions, each exceeding $1 billion (double the number of those size mega deals in 1984), but the remaining volume came upon a 12-year record in the number of M&A deals, 3001 in total last year.

M&A bankers are cautious that the boom in their field may be over. According to Grimm, once the bull kicked into gear and drove down the number of undervalued target companies, M&A activity waned toward year's end...the fourth quarter showed the least business.

The less than expected 14.3% increase can't be blamed on a weak private placement arena either. According to Investment Dealers' Digest, this area increased 38% last year, going from $53 billion in transactions in 1984 to a new record $73 billion last year. Granted, there is a small universe of securities firms doing a meaningful business in the area.

So lower rates, again, have hurt one revenue source (here repos) while conversely helping others.

EXPENSES - UNSTOPPABLE FORCE MEETS IMMOVABLE OBJECT

That nemesis of the securities industry, in fact all industries - expenses - were as always, up again last year. The good news, as mentioned earlier, is that in 1985 the industry managed to keep the increase well below its rate of revenue growth. Costs rose 16.6%, compared to a 23.7% revenue gain.

For expenses, as was true with revenues, there was practically a high-point across the board sweep of all categories in the fourth quarter of 1985. Overall, the fourth quarter's expenses aggregated $10.1 billion while in each of the first three quarters the amounts were about $8 billion. Fortunately, revenues outpaced the move jumping to $11.6 billion in the final quarter from about $9 billion each in quarters one through three.

Now for the bad news. As said earlier, when looking at the picture a little longer - two years - last year's expenses were 34.2% higher than the $25.7 billion incurred in 1983. Revenues however, increased at a slightly lower rate over the same time span - 30.4%.

Securities industry profitability, before taxes and any extraordinary gains or losses, was up a hefty 158% in 1985 on a year-to-year basis but only up 7.9% over 1983. But 1983's $3.8 billion of profits were the old record and the industry, despite cost pressures during the latest two years, appears satisfied with the new $4.1 billion pre-tax profit record under its belt (particularly coming after 1984's disappointing profit performance).

After 1984, when expenses comprised 94.8% of total revenue, it was comforting to break below the 90s barrier when 1985 expenses comprised 89.3% of all revenues. Though this reflected an important drop, it was still the second highest proportion of total revenues (or second lowest profit margin) since the late 1970s, when expenses then were also running at better than 90% of revenues. Since then, the cost/revenue ratio ran at 85.9%, 89.2%, 86.9% and 87.1% for years 1980 through 1983, respectively.

What this boils down to is that as a percentage of total revenues, expenses are moving in the right direction - down - but with plenty of room still left for improvement. In other words, the long-run trend of pressure on profit margin remains.

Hopefully, the current market environment allows for such an improvement and the data supports this hope. During the first three quarters of 1985, expenses were rising from around 89% of revenues to 92%. In the last quarter, however, this ratio dropped significantly to 87.3% of revenues. What this shows is that during the current bull market, the industry was able to keep its rising expenses (a natural phenomenon during higher activity periods) significantly under a rising revenue base. Even on a quarter to quarter basis with the final period having a practically across the board sweep in higher expenses in the aggregate, the rises trailed the sweep of revenue gains in the final quarter so that many, though not all, expense categories were showing their lowest quarterly ratio to revenues.

So the industry trend last year was being able to keep more pennies out of each revenue dollar, and most of these additional cents were kept during the bull. Furthermore, since all the trends which made the fourth quarter a winner are still in play today (in some areas even more so), 1986's first quarter should be an even better period.

PAY CHECKS: LESS PER REVENUE DOLLAR THOUGH HARDLY SCROOGE-LIKE

The securities industry's biggest asset, though off the books, is likewise its biggest expense...people. As always, one of the most costly (although profitable) category of employee is the registered rep. Last year, RR compensation increased to a new record, $6.9 billion representing 17.9% of total revenues in 1985. That is up slightly from a 16.8% share

of total revenues in 1984 but 1984 was the only year since the late Seventies when aggregate RR compensation fell from the previous year. A more indicative year to compare that 17.9% ratio was one year further back, 1983's similar bull market. In that period, RR compensation came to a much higher 19.4% of revenues. The basic trend in keeping RR costs from increasing faster than revenues is headed in the right direction and reflects the changing mix of the business. What's further encouraging is that even though this RR ratio went from 17.3% of revenues to 19.2% in the first three quarters of 1985, in the final quarter the registered rep payroll only constituted 16.5% of the period's revenues reflecting gains in the principal business. This trend again bodes well for the current year.

The second largest people expense, which historically is only a neck behind the RR in the payroll race, is clerical and administrative employee expenses. Last year was no exception, the total came to $6.2 billion. This represented 16.1% of revenues, a favorable showing since a higher 16.5% ratio in this area was experienced in each of the two preceding years. Again the fourth quarter's trend was towards a lower bite out of total revenues - only 15.7%, a full percentage point lower than the second and third quarter showings of 16.7% and 16.6% respectively, though a hair over the first quarter's 15.6%.

Even the payroll expense for partners and officers, though breaking through the billion dollar barrier for the first time last year, keeps falling as a percent of total revenues. In 1983 the compensation expense for this category was 3.3% of revenues. In 1984 it fell to just 3.0%. Last year it fell even further to 2.9% and in the final quarter the ratio was down to a mere 2.6%. Therefore, overall, the industry has been able to keep its payroll expense increase in line, and even below, its revenue growth.

INTEREST EXPENSE WENT UP DESPITE RATES GOING DOWN

One other significant expense category is interest expense. And significant it was. Last year this expense broke the $10 billion barrier for the first time and nearly doubled the level of three years earlier.

At first blush something seems to be wrong. With interest rates spiralling downward why would this category be eating up 26.2% of revenues in 1985 when it only accounted for 20.5% two years earlier and even increased to 27.6%, its highest level, in the last quarter? The answer is simple...the securities industry has been borrowing to the hilt. Total liabilities more than doubled from $146.5 billion in 1983's first quarter to $377.2 billion at last year's close. But this is a leverage

strategem and it is working. If the industry can generate a 30.4% revenue increase in two years (1983-1985) to record levels and record profits, is a 5.7%[16] bigger bite out of total revenues a high price to pay? If we think of interest expense as a function of total liabilities there has actually been a decline in relative interest expenses. The $10.1 billion in interest expense incurred last year was only 3.5% of 1985's average liabilities of $287 billion.[17] That's much better than in 1984 when it comprised 4.3% of average liabilities and even slightly better than in 1983 when the ratio was 3.6%.

KEEPING YOUR (OVER)HEAD ABOVE WATER

Given the very cyclical and service oriented nature of the securities business, fixed expenses, or overhead, are anything but fixed. Like everything else, they keep going up. What the industry wants to see is that they go up slower than revenues do, cutting less from the bottom line.

Communications costs, which include phone bills, quote machines, stationary and stamps, have followed the increases in the underlying rates from the Ma Bell, the Baby Bells and the Post Office suppliers of these services...up. These are also activity related (traders are on the horn a lot more during the bull) and the half billion dollars incurred for communications during 1985's last quarter underscores this fact (prior to 1981 no full year came to $1 billion in this area). Again the good news is that though this field is up in aggregate, it keeps taking a smaller part of industry revenues. The $1.9 billion of communications costs last year was only 5.0% of revenues, down from 5.2% and 5.7% in 1983 and 1984, respectively. It also bottomed out at a mere 4.2% in the final quarter, though that period was the highest in actual dollars. Basically, the industry seems to be getting more revenues per phone call, quote or letter it sends.

Occupancy and equipment rental expenses, which include rent, heat, lighting, maintenance, depreciation and EDP equipment rentals, are a little more tricky to look at from year to year. Some of its factors, particularly depreciation, rent and equipment rental, have a built in lag time factor. Gearing-up in 1983 to handle heavy bull market loads will more

---

16/ Interest expense as a percent of total revenues in 1985, 26.2%, vs 1983, 20.5%.

17/ Reflects a five period average: the year's beginning balance and the ending balances in each of the four quarters.

Table 5

BALANCE SHEET
TOTAL SECURITIES INDUSTRY AT DECEMBER 31
(In $ millions)

	1980	1981	1982	1983	1984	1985
ASSETS						
Cash	884.7	971.0	1937.7	1654.6	2291.9	3798.3
Segregated Cash	1454.6	1336.0	2006.7	1369.8	1162.9	1642.4
Receivables from Brokers, Dealers, and Clearing Organizations	11614.4	12371.9	20437.6	24716.2	26016.1	50503.5
Receivables from Customers	22697.6	20777.6	23728.2	31767.3	29093.3	45192.4
Receivables from Non-customers	1022.8	979.2	745.4	1215.3	1140.7	2243.4
Securities Purchased Under Agreement to Resell	31015.1	42436.5	51475.7	74903.4	104409.3	136148.2
Securities & Spot Commodities Owned	29449.7	37505.7	65314.1	70393.8	100643.1	139825.7
Securities Owned not Readily Marketable	77.0	33.6	49.0	91.9	385.2	143.9
Other Investments not Readily Marketable	31.6	43.0	38.7	52.5	60.5	61.4
Securities Borrowed (subordinated & partner's accounts)	84.7	84.7	70.8	78.0	39.8	30.7
Secured Demand Notes	269.6	238.3	242.7	256.6	340.1	323.1
Memberships in Exchanges	177.1	179.5	210.8	237.9	246.6	258.0
Investments in/Receivables from Affiliates,Subs & Assoc. Partnerships	435.3	698.1	1148.1	1667.0	2024.5	2613.6
Property, Furniture, Equipment, etc.	504.8	909.2	1413.8	1860.7	2235.9	2546.8
Other Assets	2519.2	3044.0	3617.8	4915.6	5901.8	8490.3
Total Assets	102256.7	121625.1	172436.8	215180.4	275992.1	393801.7
LIABILITIES						
Bank Loans Payable	8514.2	10286.3	9551.2	18440.8	25136.4	37423.8
Securities Sold Under Repurchase Agreements	32173.6	51693.1	74833.5	86179.7	130051.9	158867.1
Payable to Brokers, Dealers, and Clearing Organizations	10883.8	11247.6	19171.3	20610.4	21177.0	44571.5
Payable to Customers	14333.4	12517.7	15785.9	18460.0	19217.4	30561.0
Payable to Non-customers	743.2	827.4	772.9	1270.5	1227.7	2608.9
Securities Sold, Not Yet Purchased	20536.0	17736.8	28896.5	38785.6	44194.2	71458.0
Accounts Payable and Accruals	8088.8	8765.0	11971.2	16219.1	16619.3	24075.0
Notes and Mortgages Payable	148.7	384.4	641.4	914.6	1448.6	2176.8
Subordinated Liabilities	1365.8	1377.6	1741.3	2389.5	3932.1	5285.3
Total Liabilities	96899.6	114926.9	163467.6	203385.9	263177.6	377165.5
OWNERSHIP EQUITY						
Sole Proprietorship	1.7	10.1	3.3	7.5	0.9	43.4
Partnership-Limited Partners	1755.6	1641.3	2324.5	2895.4	3017.8	3171.4
Corporation						
Preferred Stock	79.5	49.8	42.5	45.7	53.1	680.5
Common Stock	91.7	433.2	488.1	508.0	532.8	606.5
Add. Paid-in Capital	1251.3	1692.2	2312.5	3207.8	4080.1	5671.1
Retained Earnings	2222.2	2895.5	3850.4	5160.0	5162.6	6514.6
Corporation Total	3644.7	5070.7	6693.6	8921.5	9828.4	13473.6
Less Capital Stock In Treasury	-44.8	-40.4	-53.4	-29.5	-32.3	-32.0
Total Ownership Equity	5357.2	6680.0	8969.8	11796.5	12814.7	16651.2
Total Liabilities and Ownership Equity	102256.7	121625.1	172436.8	215180.8	275991.1	393932.6

likely show up as increased expenses in following years. The full impact of adding more space will be reflected in following years' lease and rental figures as would the depreciation of added new equipment and EDP equipment rental fees.

In 1984, for example, this expense category jumped both in aggregate, $1.1 billion to $1.5 billion, and took a bigger slice of total revenues, 4.8% vs. 1983's 3.9%. However, last year's $1.8 billion occupancy and equipment expense used up a slightly smaller (than 1984) 4.7% of revenues, with the fourth quarter using the least of all quarters, 4.3%. Some other factors which helped keep last year's expenses down and should also help even more in 1986 are reduced heating and lighting costs, with oil prices plummetting, plus minimal inflation rates.

THE BALANCING ACT

The total industry's balance sheet (again from NYSE firms doing a public business) has exploded in just a few years. At 1983's onset, the industry boasted assets of $172.4 billion. By last year's close, that had mushroomed 128% to $393.8 billion. Most of the growth was leveraged. Total liabilities over the same time frame grew 130% to $377.2 billion as of December 31, 1985. Total ownership equity, while having expanded to a record $16.7 billion as of that date, grew at a smaller 86% rate over the same period.

Total ownership equity barely grew from 1983's close to 1984's end, up $1 billion or 8.5%. However, from that point on until the end of 1985, the increase blossomed $3.9 billion or 30.5%. Practically the entire increase occurred in last year's final quarter. During those three months, three categories of equity were substantially increased and accounted for the bulk of the year's total increase. Preferred stock outstanding, having hovered in the $40 to $50 million range since 1983's start, grew to just under $80 million in the second and third quarters of 1985 and then shot through the roof, topping out at $681 million as of December 31. That was a 1,185% year-to-year increase. Common stock equity (par value plus paid in capital) has grown from $2.8 billion as 1983 began to $6.7 billion at 1985's close. Amazingly, $2 billion of that increase came in fourth quarter, 1985. Retained earnings, which rose from about $4 billion at 1983's start to $5.2 billion at 1985's start, jumped another $1.3 billion last year with half that gain coming in the final quarter.

Half of last year's $1.7 billion increase in common stock equity (including paid in capital) came from eight new issues of stock through public underwritings and private placements, according to Investment Dealers' Digest. The bulk of the remaining half, particularly in light of the preponderance of the increase coming in the fourth quarter, is mainly attributed to a lot of stock option exercising to capitalize on the market

Table 6

1985 QUARTERLY BALANCE SHEET
TOTAL SECURITIES INDUSTRY
(In $ millions on last day of quarter)

	1985:1	1985:2	1985:3	1985:4
ASSETS				
Cash	2044.5	1951.4	2303.6	3798.3
Segregated Cash	1377.2	1221.5	1218.6	1642.4
Receivables from Brokers, Dealers, and Clearing Organizations	27659.0	33079.9	32582.4	50503.5
Receivables from Customers	27768.8	33464.6	35729.5	45192.4
Receivables from Non-customers	982.2	1313.1	1116.9	2243.4
Securities Purchased Under Agreement to Resell	102610.3	104856.4	111150.0	136148.2
Securities & Spot Commodities Owned	81374.2	95140.7	102126.7	139825.7
Securities Owned not Readily Marketable	199.1	146.4	152.2	143.9
Other Investments not Readily Marketable	53.8	54.8	60.3	61.4
Securities Borrowed (subordinated & partner's accounts)	43.4	46.7	25.0	30.7
Secured Demand Notes	317.1	315.3	309.6	323.1
Memberships in Exchanges	248.9	244.3	246.9	258.0
Investments in/Receivables from Affiliates,Subs & Assoc. Partnerships	2074.5	2221.8	2737.7	2613.6
Property, Furniture, Equipment, etc.	2283.8	2132.3	2148.7	2546.8
Other Assets	5631.9	6160.7	6760.8	8490.3
Total Assets	254668.8	282350.4	298669.4	393801.7
LIABILITIES				
Bank Loans Payable	19229.0	26676.6	26640.0	37423.8
Securities Sold Under Repurchase Agreements	112778.4	117940.5	126782.9	158867.1
Payable to Brokers, Dealers, and Clearing Organizations	24729.9	28728.6	28479.7	44571.5
Payable to Customers	18627.0	22310.6	22442.8	30561.0
Payable to Non-customers	1128.8	1184.2	1135.5	2608.9
Securities Sold, Not Yet Purchased	47028.0	51126.3	55399.0	71458.0
Accounts Payable and Accruals	13590.5	15704.4	18074.8	24075.0
Notes and Mortgages Payable	682.8	749.2	883.3	2176.8
Subordinated Liabilities	3818.4	4114.7	4445.3	5285.3
Total Liabilities	241732.0	268636.0	284382.4	377165.5
OWNERSHIP EQUITY				
Sole Proprietorship	0.4	0.0	1.6	43.4
Partnership-Limited Partners	3111.0	3363.0	3509.3	3171.4
Corporation				
Preferred Stock	36.1	76.6	78.7	680.5
Common Stock	530.6	576.2	571.8	606.5
Add. Paid-in Capital	3904.9	3974.0	4253.0	5671.1
Retained Earnings	5389.9	5850.7	5907.0	6514.6
Corporation Total	9861.3	10477.3	10810.6	13473.6
Less Capital Stock In Treasury	-33.9	-37.6	-33.9	-32.0
Total Ownership Equity	12936.9	13714.2	14299.8	16651.2
Total Liabilities and Ownership Equity	254668.9	282350.4	298669.2	393932.6

run-up. Securities firm stocks were continuously posting new 52-week and all time highs during the quarter and the time was ripe for exercising these options. However, a single $75 million sale of preferred only made up a fraction of last year's $627 million increase in preferred equity but the balance was likewise assumed to have come from internal capital infusions.

A RETURN TO RETURN ON EQUITY

As a group, the securities industry is now headed back to levels of profitability comparable to its best years of the past.

The return on equity[18/] earned last year easily outpaced 1984's poor showing. On a pre-tax basis, 1985's 29.4% ROE outdistanced by a few furlongs 1984's 13.3% showing, the worst in recent memory. Nevertheless, it did not match the 36% to 41% return in the other three years since phenomenal 1980 (that year a 49.2% pre-tax ROE). However, as said earlier, the profitability rebirth began in the fourth quarter and continues to date. In that period, pre-tax ROE jumped to 38.1%, clearly in line with the three best years since 1980.

On an after-tax basis the trend again bodes well for 1986. Last year's 15.9% ROE also left 1984's rate in the dust, then a meager 7.2%. The final quarter last year once again shows a marked improvement in this area - up to 20.6%, right in line with the 19% to 22% returns shown in years 1981 through 1983.

Moreover, this return on equity had to be earned on an increasingly larger equity basis. As said earlier, over a 36 month period (January 1, 1983 through December 31, 1985) the total equity ownership base jumped 86% to $16.7 billion.

Other measures of profitability followed suit. As briefly discussed earlier under revenues and expenses, the industry's profit margin, both on a pre-tax and after-tax basis, has rebounded back from 1984's depths and in the final quarter shot up even further to match the levels of the early 1980s.

NOW THAT WE'RE HERE, WHERE ARE WE GOING?

What the previously discussed increases mean, and the industry certainly hopes will be borne out, is that all the

---

18/ Annual ROE is determined by net income divided by a (five period) average total equity (the year's opening balance plus the four quarterly closing balances). Quarterly ROE is determined by an annualized net income divided by a (two period) average total equity (the quarter's opening and closing balance.

Table 7

RATIO REPORT
TOTAL SECURITIES INDUSTRY

	1980	1981	1982	1983	1984	1985
PROFITABILITY (%-Annualized)						
Profit Margin-Pre-Tax	14.1	10.8	13.1	12.9	5.2	10.7
Profit Margin-After Tax	7.6	5.8	7.1	7.0	2.8	5.8
ROA-Pre-Tax	2.8	2.1	2.3	2.1	0.7	1.4
ROA-After Tax	1.5	1.1	1.3	1.1	0.4	0.7
ROE-Pre-Tax	49.2	35.9	40.5	36.6	13.3	29.4
ROE-After Tax	26.6	19.4	21.9	19.8	7.2	15.9
Earnings Growth (%Ch, Year-ago)	105.7	-5.2	41.5	26.0	-57.9	157.5
PRODUCTIVITY (Annualized)						
Asset Turnover	0.20	0.19	0.18	0.16	0.13	0.13
Capital Turnover	2.77	2.72	2.59	2.37	2.03	2.10
Revenue Per Employee	114,641	123,242	135,758	154,016	150,455	179,951
LEVERAGE (Ratios)						
Equity to Total Capital	0.797	0.829	0.837	0.832	0.765	0.759
Equity to Total Assets	0.052	0.055	0.052	0.055	0.046	0.042
Short to Long Positions	0.697	0.473	0.442	0.551	0.439	0.511

RATIO REPORT
TOTAL SECURITIES INDUSTRY

	1985:1	1985:2	1985:3	1985:4
PROFITABILITY (%-Annualized)				
Profit Margin-Pre-Tax	10.4	11.1	8.0	12.7
Profit Margin-After Tax	5.6	6.0	4.3	6.9
ROA-Pre-Tax	1.4	1.5	1.0	1.7
ROA-After Tax-Pre-Tax	0.8	0.8	0.5	0.9
ROE - Pre-Tax	29.0	30.8	20.2	38.1
ROE - After-Tax	15.7	16.6	10.9	20.6
Earnings Growth (%Ch, Year-ago)	82.8	NM	2.2	193.3
PRODUCTIVITY (Annualized)				
Asset Turnover	0.13	0.14	0.12	0.13
Capital Turnover	2.14	2.14	1.93	2.28
Revenue Per Employee	172,497	174,751	162,597	209,902
LEVERAGE (Ratios)				
Equity to Total Capital	0.772	0.769	0.763	0.759
Equity to Total Assets	0.051	0.049	0.048	0.042
Short to Long Positions	0.578	0.537	0.542	0.511

factors in last year's final months that have elevated the securities industry back to its former profitability days are in place this year and are driving the industry towards its possibly best ever showing. Certainly 1986's first quarter is now expected to be one of, if not the best, quarter ever for the industry as a whole.

Some factors to watch this year are:

1. Interest rates: their continuing decline is fueling both the primary and secondary corporate debt and equity markets. Corporate bond underwritings continue at a record breaking clip while equity, though not yet at 1983's torrid pace, is still incredibly strong. The secondary trading markets for bonds and equity are mirroring their primary market cousins. These factors will determine how the industry's commission and trading gain revenues will fare.

2. Equity markets: the run-up in this area has been fast and steep and though driven by favorable economic and rate environments it is still a fragile customer towards psychology and thus could come to an abrupt halt. Continued gains here will help trading profits and commissions but hurt M&A activity since it dries up the pool of undervalued target companies.

3. Washington: proposed tax legislation is often as damaging as its enactment. The municipal market already learned this lesson. The Eurobond business may be in for a jolt if a withholding tax is reimposed. Additional 20% minimum tax proposals are again troublesome to the muni market.

4. Overcapacity: every time the market goes wild, as it has been recently, securities firms add capacity in the form of RRs, equipment and work space. Then when it goes bust its cut-back time again.

5. Balancing opposing forces: just because your RRs margin accounts are active and way up don't assume your revenue is increasing. Falling rates, as seen earlier, have kept revenues from this field from matching the increased activity in it. The same is true with commissions. Though trading is heavier, reduced commission rates have prevented revenues from keeping pace with the added activity.

Though there are always pitfalls along the road, based on how the year just past signed off, this year's path for the industry in general may prove to be a rosy one indeed.

George R. Monahan
Assistant Director
of Research

VOLUME

	FEBRUARY 1986	JAN - FEB 1986	FEBRUARY 1985	JAN - FEB 1985	% CHAN. J-F 1986-1985
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	152.6	141.8	115.5	118.5	19.6%
AMEX (MILS.)*	14.0	12.6	10.3	9.7	29.4%
NASDAQ (MILS.)*	121.9	115.8	91.2	87.7	32.1%
REGIONAL EXCHANGE (MILS.)*	25.3	23.8	20.0	19.7	21.1%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$108,415	$213,425	$76,036	$165,271	29.1%
AMEX (MILS.)	2,654	5,712	2,630	4,560	25.3%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,250	16,519	6,273	13,757	20.1%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	19,145	37,734	15,436	33,106	14.0%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.6%	49.6%	50.7%	51.0%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	15,851	31,077	11,223	25,176	23.4%
AMEX OPTIONS	4,905	10,478	2,866	6,217	68.5%
COMMODITY	15,764	32,043	12,812	26,065	22.9%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

YIELDS

(MONTHLY AVERAGES)

	MARCH 1986	MARCH 1985	BASIS POINT CHG 1986-1985
BOND BUYER INDEX (20 BOND)	7.44%	9.65%	(221)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.67	12.13	(246)
Baa CORPORATE	11.11	13.23	(212)
RATIO Aaa CORPS. TO Baa CORPS.	0.87	0.92	(5)
MUNICIPAL BOND YIELDS (MOODY'S)	7.44	9.65	(221)

PRICES

(END OF MONTH)

	MARCH 1986	MARCH 1985	% CHAN. Y-T-D 1986-1985
DOW JONES INDUSTRIALS	1818.61	1266.78	43.56%
STANDARD & POOR'S 500	238.9	180.66	32.24%
NYSE COMPOSITE	137.71	104.6	31.65%
AMEX MARKET VALUE INDEX	270.03	229.59	17.61%
VALUE LINE COMPOSITE	242.23	194.53	24.52%
NASDAQ COMPOSITE	374.72	279.2	34.21%

UNDERWRITING

	FIRST QUARTER 1986	FIRST QUARTER 1985	1ST Q'86-1ST Q'85 % Change 1986-1985
CORPORATE FINANCING (Gross New Issues - Millions)			
TOTAL	68.0	21.3	219.2%
Common Stock	8.7	4.3	102.3%
# of Common Stock Issues	205	128	60.2%
Preferred Stock	3.8	1.0	280.0%
# of Preferred Stock Issues	39	15	160.0%
Corporate Debt	55.5	15.9	249.1%
# of Corporate Debt Issues	543	232	134.1%
MUNICIPAL FINANCING (Gross New Issues - Millions)			
Notes	N/A	N/A	N/A
Bonds	11,351	21,737	-47.8%

Source: IDD and Salomon Brothers

MARGIN DEBT

	FEBRUARY 1986	FEBRUARY 1986	% CHANGE 1986-1985
MARGIN DEBT OUTSTANDING ($MILS)	27,450	22,970	19.5%
NET CHANGE IN MARGIN DEBT ($MILS)	4,480	640	600.0%
% OF ACCOUNTS WITH EQUITY UNDER 40%	10%	10%	-----

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Transcript of SIA's 7th Annual Trends Conference on Distribution and Changing Customer Needs	A complete transcript of speakers at the 1/22/86 Conference including all the tables and charts presented. Topics on current and future distribution techniques discussed at the conference ranged from retail, institutional and international distribution problems and trends to discounting and technology's role in distribution strategies.	SIA Cost: $75
"First Quarter Domestic Corporate Financing 1986"	A quarterly record $68 billion in corporate underwritings were completed in 1986's Q1. Salomon Brothers again topped the manager rankings. Contained is a complete listing of top 15 book managers of these financings, with Q1 1986 compared to Q1 1985.	Investment Dealers' Digest, 4/7/86 150 Broadway New York, NY 10038
"Salomon's Power Culture"	This story characterizes Salomon Brothers as an anomaly, albeit a rich and powerful one, in investment bank management style.. Besides labeling the firm a "trading oriented" culture, the article alternately portrays the firm's captain, John Gutfreund, as a self-effacing laid-back soul to that of a shrewd businessman who wrested control of Salomon from Phibro CEO David Tendler less than five years after Phibro bought Salomon out. Good reading for both Salomon insiders and outsiders.	Institutional Investor, 3/86 488 Madison Avenue New York, NY 10022

"The New Wave of Corporate Raiders"	Article dealing with the likely successors to the Irwin Jacobs and T. Boone Pickins of this world. Story identifies and categorizes a good list of takeover artists giving their track record, methodology and styles.	Financial World, 4/1/86 1450 Broadway New York, NY 10018
"Financing Techniques: What's Hot, What's Not"	Atricle dealing with what financing techniques are heating up in the corporate primary market and what ones are cooling off. For each category, such as the "hot" medium-term notes and the "not hot" yield curve notes, the story shows how many deals and for how much, the frequent underwriters, and how the deals work. Also, their "hot" or "cold" status and examples of recent issues are contained.	Investment Dealers' Digest, 3/17/86 150 Broadway New York, NY 10038
The Future of Technology in the Financial Services Industry	A study outlining the great impact electronic technology has made on the financial services industry and key issues which are of concern today such as computer security, executive comfort with technology planning and technology's strategic advantage. Commissioned by C&L, the study was conducted through interviews with 250 top executives in the nations largest brokerage firms, investment companies, syndicators, insurance companies and commercial banks.	Coopers & Lybrand 1251 Avenue of the Americas New York, NY 10020
"Bank Supervision in a Changing Financial Environment"	On 1/30/86, Federal Reserve Bank of New York President E. Gerald Corrigan addressed the New York State Bankers Association on the topic of what the New York Fed saw as a need to strengthen the supervision of banking organizations. This is a transcript of his address.	Federal Reserve Bank of New York Quarterly Review, Winter 1985-86 33 Liberty Street New York, NY 10045
More Words of Wall Street	A sequal to the original and popular "Words of Wall Street" published in 1983. The new dictionary will list approximately 2,000 Wall Street jargon words, most not included in the 2,000 from the original version.	To be available in bookstores this summer

* * * SPECIAL OFFER * * *

You may now order copies of the Transcript of the 1985 Trends Conference: Keys to a Changing Securities Industry at the greatly reduced price of $15.00 per copy. The Conference focused on the results of the Delphi study on the impact of today's major trends on the securities industry in the late 1980s. The transcript includes an in-depth analytical presentation of the results of the study and panelists' speeches on the implications of these results for specific segments of the business. Topics covered include: cost control, opportunities and concerns of the 1980s, the retail securities business and competition. To obtain a copy, please use the order form below.

- -

ORDER FORM

TRANSCRIPT OF THE 1985 TRENDS CONFERENCE:
"KEYS TO A CHANGING SECURITIES INDUSTRY"

Name _____

Company _____

Address _____

City _____ State _____ Zip _____

Price per copy: $15.00

Number of copies ordered: _____

Total amount enclosed: $(U.S.) _____

(All orders must be pre-paid)

Please make checks payable to: Securities Industry Association

Please return to:

Research Department
Securities Industry Association
120 Broadway - 35th Floor
New York, NY 10271